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Focusing on the Few:
The Role of Large Taxpayer Units in the Revenue Strategies of Developing Countries

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In order to understand the reason for poor performance of the revenue administration, we must first look 'outside the box' , beyond the organizational boundaries of the revenue administration, and analysis the impact of important environmental factors on its performance .

Jit Gill, World Bank (2003)

Introduction

The opening quotation from Jit Gill challenges students of tax administration reform to look "outside the box", to reject narrow diagnostics and operational solutions to tax compliance, grounded purely in administrative theory and technology fixes, in favor of approaches based on a broader political economy of tax administration. This paper adopts such a broad approach to explain and evaluate one of the most important, but least analyzed, tax administration innovations of the last two decades. This innovation is the large taxpayer unit, (LTU) along with the associated taxpayer segment or client organizational framework for improving taxpayer compliance. The increasing reliance on LTUs as a strategic organizational tool in over fifty developing and transition countries from Argentina to Afghanistan makes this innovation an important topic for public sector analysis.

The classic LTU monitors large taxpayers exclusively through auditing, registration, tax accounting, collections, and taxpayer service provision covering more than one type of tax. LTUs have facilitated major tax policy reforms, such as adoption of a VAT, as well as the reform of administrative procedures, including implementation of self assessment, modern auditing, electronic filing of tax statements, and the functional organization of work by first incubating these changes.

The LTU have been described as a potential Trojan horse for reform in tax administrations that have become seriously dysfunctional or, worse, completely captured by corrupt administrators. As such, it has been used as an institutional reform substitute for a semi autonomous revenue agency. Although many of the business processes and service innovations begun in LTUs are intended for scaling up to cover the entire tax system lower income countries with weak administrative capacity have experienced difficulties in pursing this path to comprehensive administrative reform. The successful reforms incubated in an LTU can demonstrate to the tax administration management, who are often hostile to change, that it is possible and advantageous to modify systems and procedures. IMF reports on the LTU stress the need to integrate LTU practices into "a broader tax administration reform also aimed at improving the administration of the medium-size and small taxpayer" and need to "prevent the LTU from being perceived as a 'parallel' tax administration "[1].

Most recently, the LTU have been established in a number of developing countries that already have a semi-autonomous revenue agency (SARA). This development indicated that the LTU can play a complementary role to the broader institution of a SARA. Many SARAs have not been able to sustain the improvements in revenue that have been achieved initially, have not effectively integrated taxpayer information across tax types and third party information flows for systemic improvement of audit, and have not always achieved the major improvements in integrity and professionalism that were anticipated from human resource management flexibility.

Some developed countries (e.g., Netherlands) and developing ones (e.g., Pakistan) have gone beyond establishing LTUs to reorganize administration around different size segments of taxpayers. The rationale for this approach is that each size group of taxpayers has different characteristics and tax compliance behaviors and, consequently, each presents different risks to the revenue base. According to this management philosophy, maximizing voluntary compliance for each taxpayer segment requires delivering a set of strategies that are appropriate to the unique characteristics and compliance issues posed by each group. The extreme heterogeneity of business taxpayers in developing countries makes this case persuasive. Many developing counties have adopted a hybrid approach, by starting with an overall functional design, but subsequently grafted components of the segment approach on to their organizational designs. Although many transition countries quickly adopted modern tax legislation in the early 1990s the reform of tax administration has lagged substantially behind policy. Transition economies have used LTU to facilitate speedy tax administration modernization and to cope with weak taxpayer compliance, partially driven by overly generous tax holidays.

[1] Baer, (2002) ,p.39

Part I of this paper first reviews the spread of LTUs, and briefly describes the experience of LTUs in a few selected countries. This section takes up the question of the LTU as an enclave administrative reform versus semi-autonomous revenue agencies and "whole of government" reform involving broad based wages, human resources planning and anti-corruption measures. Part II examines the emergence of the LTU and its relationships to the remainder of the tax administration system in different kinds of developing and transition economies, such as *(i)* capable developing states, *(ii)* administratively weak but governance improving states, and *(iii)* captured states. The relative success of LTUs can improve our understanding of the enclave approach to governance reforms as well as yielding insights that are intrinsic to the challenge of improving revenue mobilization. LTUs and their roles in developing country economies can also be interpreted through the prism of recent revisionist writings on best policies for the tax mix in the presence of a major informal sector and a government sector with a highly constrained taxing capacity and high vulnerability to corruption

Naturally, LTUs in developing countries should be evaluated quantitatively in term of their stated aim of increasing tax compliance relative to the compliance performance of similar countries without LTUs and compliance in the same country before the LTU was instituted. Part III of this paper addresses revenue impacts with a cross sectional econometric investigation of the determinants of the C-efficiency of a tax rate point of value added tax including explanatory variables that capture LTU treatment effects.

Part I: Environmental Factors Impacting Tax Administration

Tax Administration in Developing and Transition Economies

Tax administrations in many developing countries are organized by 'type of tax' with additional tiers of organization determined by geographic. This design is tied to the belief that close geographic proximity should be maintained between taxpayer and tax collector. The geographic dimension is usually based on circle and zonal offices, where tax officers specialize, not in a few specific administrative functions, but in acquiring an intimate knowledge of the businesses of those taxpayers whose assessments they finalize. Tax administrative work in such a traditional setting has a low incremental revenue productivity because of inadequate specialization of tasks and an inability to concentrate resources on the high risk components of the revenue base. Excessive direct contract between taxpayers and tax officers exposes the tax administration to a unnecessary risk of corruption, because final tax liabilities are often negotiated at face to face meetings.

This type of tax and geographic approach results in administrative units that are ill suited for effective use of information technology and for the monitoring of staff performance. The span of subordinate units covered by senior managers is generally narrow, leading to unnecessary layers of middle management and little opportunity for functional specialization by mangers and their staff. In countries where this organization structure has been retained, populations growth and growth of the size of the formal economy implies that the low productivity circle office design must be replicated many times. The forces of inertia that cause traditional administrative structures to be retained include the lobbying power of civil service unions and pressure to keep unnecessary management staffing positions for the promotion of middle manager.

Economies in transition have their own tax administration problems that differentiate them from developing countries. Specifically, transition tax administrations have a culture of mutual mistrust between tax payers and the tax authorities; no tradition of voluntary compliance with tax legislation; no tradition of appeals to the courts against the decisions of the tax authorities ; no tradition of self-assessment, which would shift the burden of appraisal to the private sector and reduce administrative demands placed on the tax authorities and a tradition of strong tax illusion due to taxes being withheld through bank accounts.

By contrast, modern tax administrations are built around organizational designs that facilitate specialization of tasks, integrated decision-making, coordinated implementation of policies and business practices, and effective monitoring of overall performance.[2] A modern organizational structure for a revenue administration will enable senior management to allocate routine and standardized work to specialized units supported by information technology, while

[2] This argument follows Mintzberg (1983) .

assigning most highly-trained talent to high productivity tasks that require problem solving and evaluative skills, such as auditing, evaluation of management information reports, and dealing with taxpayer disputes. In practice, these conditions have been met by adopting a functional organization to the broad activities of registration, collections and accounting, auditing, taxpayer services and enforcement. In the functional model, staff work in specific functions, such as registration, information processing, audit, taxpayer education and services, but are involved in all types of taxes. The functional approach to work design permits greater standardization of similar processes across taxes, facilitates simplification for taxpayers, and enables greater productivity to be achieved. Standardizing processes across taxes also facilitates their automation and deters malfeasant behavior by staff. But increasingly, the functional approach is being combined with the client or tax segment taxpayer design.

Moving to Self Assessment and Functional Organization

Administrative assessments performed by government tax officers under income tax and VAT are costly. Where self assessment is not the norm, the revenue authorities impose assessments based on taxpayer declarations and desk audits. After meeting with the taxpayer and examination their books of account, discrepancies often form the basis for the negotiation of an agreed assessment. Confronted with high assessment targets, tax officers usually complete the majority of assessments in a perfunctory manner, so that the tax administration has only a marginal impact on voluntary compliance and tax evasion. Alternatively, revenue targets may be achieved by adoption of arbitrary procedures and harassment intended to intimidate taxpayers, particularly those with a perceived high ability to pay. The absence of self assessment encourages taxpayer disputes and imposes significant compliance costs on taxpayers. The extensive contact between tax-payers and tax authorities creates opportunities for bribery and associated loss of revenue.

Self assessment should enable tax administration departments to re-deploy their resources in a more productive manner and reduce compliance costs for honest taxpayers. But self assessment can poses significant risks. If it is not implemented properly over the longer term self assessment could do substantial fiscal damage. Self assessment is based on the presumption that it is possible to achieve a reasonable level of tax compliance by test checking a small sample of returns. The success of the self assessment strategy hinges on taxpayer perceptions. If the taxpayers perceive that (a) the chances of their being caught with continued evasion are high and (b) that they would face serious consequences once caught, then the level of compliance will rise. If on the other hand, taxpayers believe that the administrators do not have the capacity to detect tax evasion, or that, even if it does succeed in detecting evasion, they can escape punishment through bribery, political influence, or tax appellate and court processing delays, the compliance level will fall. The creation of a credible deterrent to tax evasion and the effective internal supervision of staff are the joint key to the success of the self assessment strategy. It requires initiatives touching almost all aspects of the management and operations of the tax administration departments including office training, new approaches to audit selection, a reorientation of departmental resources and legal changes and measures to develop a culture of compliance within the broader society.

Many developing countries switched to self assessment during the 1990s, although South Asia and much of Africa and East Asia are still in the process of implementing such a change. Although Ebrill et al. (2002) emphatically advise that VAT should be administered on a self assessment basis, many economies in transition have stubbornly rejected this advice throughout the last decade and half. The larger countries of Latin America, notably Chile and Argentina, implemented functional organization reforms in the 1960 and 1970s with advice and technical support from the USA's Internal Revenue Service. And in the cases of Chile, the modern organizational structures and ethos were absorbed so well that internal enclaves of administrative excellence have not been required. However, many developing countries have inadequate internal capacity to implement such multi-dimensional administrative change. Hence comprehensive tax administration reforms (e.g.: Tanzania, Kenya, and Nepal) are increasingly undertaken as multi-year tasks guides with technical assistance funded by external resources.

Coping with Globalization and the Informal Sector

In an era of globalization the profiles of taxpayers in non-OECD countries can be categorized broadly into three diverging groups: (i) large taxpayers who use sophisticated means to minimize their tax burden and interact with the tax authorities both as tax collecting agents of the government and as taxable clients; (ii) small and medium enterprises in the formal sector who maintain weak accounting documentation of their business activities and ultimately negotiate their assessments in an environment that is vulnerability to bribery, and (iii) informal sector businesses that may not pay direct taxes but pay indirect taxes through their purchases of goods that attracted custom duties and domestic VAT payments. The business operations of large taxpayers are complex; they have high transaction volumes and they act as withholding agents for the taxes of other taxpayers. Very often large taxpayers are branches of foreign enterprises or they themselves own branches abroad leading to issues of how their global profits will be distributed across tax jurisdictions. Large taxpayers employ highly qualified accountants and lawyers and sometimes they use forms of avoidance that are difficult to detect, such as abusive transfer pricing and thin capitalization strategies. These characteristics make it desirable to monitoring large taxpayers with staff having highly specialized personnel in accounting and auditing. International constraints that impinge on tax administration of large taxpayers require additional skills, such as implementation of tax treaties with other countries. However, the very different client characteristics of SMEs and informal sector businesses indicate the need to adopt t separate approaches with simplified procedures and forms and appropriate changes in the law both to facilitate legal use of specialized windows as well as to ensure that enterprises are classified to the appropriate tax segment.

Implication of the Non-Taxpaying Informal Sector

The presence of large informal sectors in developing countries reflect partially lower rates of urbanization, high rates of illiteracy, and government policies promoting informal sector industries, but also very high fixed costs of entry into the formal economy. Aurioll and Warlters (2003) have attributed to governments in developing countries a kind of super-rationality to explain the seemingly irrational commitments to maintaining high barriers to entry from the informal to the formal sector. These barrier impede access to banking credit and legal entitlements associated formal status that deters invest and broad based economic growth as eloquently explained by de Soto and analyses in the tax mix theoretical literature by Emran and Stiglitz (2003). In their interpretation, developing countries with weak tax administration capacity and revenue organizations that are vulnerable to tax leakages when tax collections are focuses on informal sector business or the borderline sector consciously raise barriers to entry in an effort to maximize tax revenue without improving tax administration capacity. By generating market power, and hence rents, for the permitted entrants, market entry fees foster the emergence of large taxpayers. As barriers to entry they create market power for firms whose rents are subsequently captured by the government though direct taxes on monopoly profits at a low administrative cost. This argument can also be extended to cover a wish to concentrate rents that can easily be harvested in captured state. They note the skewed distribution of tax revenue by size of taxpayer turnover. Few taxpayers account for a large proportion of total tax collection in developing countries.

Table 1

Concentration of tax collection in selected countries—2000

	Number of large taxpayers	*% of total*	*% of revenue*
Argentina	3,665	0.1	49.1
Benin	812	1.0	90.0
Bulgaria	842	0.1	51.4
Hungary	369	0.1	42.1
Kenya	600	0.4	61.0
Peru	2,450	0.9	64.9
Philippines	833	0.2	36.0

Source: Bodin

For instance Baer (2002) reports that 0.4% of tax payers account for 61% of total domestic tax collection in Kenya and 57% in Colombia. Aurioll and Warlters advocate the use second level counteracting discrimination to encourage small entrepreneurs to register under a special status created for them without having larger large taxpayers doing the same. LTUs could be key actors in this reform by their monitoring of large taxpayers.

Drawing upon the theoretical work in Emran and Stiglitz (2002), Stiglitz (2003) has recently argued that the existence of a large informal economy makes the VAT inefficient in most developing countries. Because VAT is a tax on the formal sector impedes development through a host of general equilibrium distortions. Stiglitz believes that developing countries that impose a VAT, "perversely encourage production to remain in the informal sector, which often produces the goods that are consumed domestically or used as inputs in the developed world." As an alternative, Stiglitz proposed greater reliance on direct taxes and import tariffs (customs). However Stiglitz overlooks the role of tax administration in his analysis. By not endogenizing tax administration effort he wrongly attributes to VAT the main role of causing non-neutrality between formal and informal sectors, while ignoring the inequitable tax administration effort across taxpayer size segments and neglecting the information complimentarily between company income tax and VAT when LTU administrative techniques are effectively employed.[3].

Emergence and Spread of LTUs

Large taxpayer units has spread to over fifty counties by 2004 largely, though not exclusively, among the developing economies. This organizational form began in Argentina in the late 1970s and were copied by other Latin American countries, notably Peru, Bolivia and Uruguay, in the early 1980s. With the encouragement of the IMF and some bilateral donors it spread to several smaller African countries in the early 1990s, to transition economies in the mid 1990s,starting with Hungary, and finally to South and East Asia in the first decade of the 21st century.

In the case of Argentina the focus was made more efficient and systematic in the early 1990s through the development of a computer-based accounting system, initially for the control of compliance with filing and payment for the 2,000 largest taxpayers. This system has been progressively extended to cover 230,000 large and medium size taxpayers, although a single LTU in Buenos Aires monitors only 3,700 taxpayers who account for approximately 50 percent of all revenue generated. The Argentine large taxpayer software was applicable to all taxpayers so that -the LTU in this case performed the role of a “good trojan horse” [4] for improvement. But, as reported by Baer (2002), the strategy failed to meet the needs of small taxpayer because of constraints of the tax administration’s. Eventually, the Argentine authorities attempted to respond by setting up a simplified tax regime for small taxpayers

Writing for a CIAT technical conference in the early 1990s Vazquez-Caro (1994) offered an explanation of the direction and motivation of Latin American tax administration innovation during the preceding decade that is well worth quoting. “The rationale for this approach [creating

[3] Concern about the appropriateness of VAT for lower income developing countries is not new. Shoup (1988) notes that the “VAT is not ideal for all developing countries” and lists several factors which affect this including those countries where retail trade is fragmented among very small traders, discrimination among investment goods is not considered harmful, basic accounting is not widespread, and efficient and impartial administration has not been achieved. This problems is dealt with in low income countries with low literacy by establishing a high threshold for compulsory participation of dealers in VAT

[4] A phrase suggested to the author by Jaime Vázquez-Caro

a segmented unit for large taxpayer] was that the individual importance of {these} taxpayers on total collection made a close monitoring decisive. This focus of collections on a few taxpayers derived not only from the high concentration of income in the country, but also because of the increasing transfer to the private sector of tasks previously handled by tax officials From having been originally large taxpayers , these companies became large collectors of withholding and VAT." Hence the rise of payroll taxes, public pension plans in the formal sector, and the increased dependence on VAT in the Latin American revenue mix has turned large companies into major tax collection agents for government.

The inefficient side effects of adopting this attractive solution to the tax collection problem was also a substantial loss of interest throughout Latin America in efforts to achieve an equitable rate of compliance by small and medium taxpayer. Vázquez-Caro (1994) cautions that the segmentation of the organization based on taxpayers size poses an observational challenge to overcome problems of asymmetric information in recognize and monitor taxpayers without creating a unit to do so.[5] Even at the end of the 1990s this weak compliance record remains a major issue in Brazil, where, as identified by Tendler (2002), regional politicians ensure a type of informal tax holiday to industrial clusters of SMEs in order to preserve jobs for their communities.

Segment or Client Model

Another alternative recently adopted by a few developed countries such as Netherlands and Australia is the taxpayer segment or client model. Pakistan since 2002 have attempting to implement an authentic taxpayer stratified segment approach, with different taxpayer service for small , medium and large taxpayers. In order to improve voluntary compliance for each specific group of taxpayers, the tax authority needs to tailor and deliver a set of strategies that are appropriate to the unique characteristics and compliance issues presented by each group. Such

[5] Vázquez-Caro suggests that the more intense monitoring in Argentina led to efforts to the break up of large companies and to the pretend dwarf phenomena detected in Mexico. "Large taxpayers start breaking down into smaller units as happened in Argentina, where the large taxpayer unit eroded overtime due to this tendency to stay away from the ¨special¨ treatment. To drop out was easy because the rest of the organization--due precisely to the emphasis on large taxpayers--was unable to track them to put them back in."

strategies can include targeted audit action, law clarification by public rulings, and specific taxpayer education initiatives.

Reasons for Adoption of an LTU

The most fundamental goal of LTUS according Baer (2002) has been to improve the level of compliance among large taxpayers and to act as a pilot or incubation center to test administration reforms later extended to the rest of the taxpayers. Additional reasons stressed by Bodin (2002) and dos Santos (1994) are to improve the management of arrears and the speed of collections in a systematic monitoring an objective which has major present value revenue consequences in economies subject to high rates of inflation. [6] Bodin stresses that LTUs are increasingly being employed to support major tax reforms (e.g., VAT) in countries with weak administrative capacity, to facilitate allow introduction of major tax administration reforms (e.g., function-based organization and self-assessment procedures) and to signal government's commitment to enforce tax laws to the taxpayer community. A final rationale for establishing an LTU is to improve business climate, particularly for direct foreign investment by providing sophisticated services such as advance rulings to large clients and to reassure investors that they assessment and audits will be dealt with in a fair and transparent manner. Direct foreign investors often fear harassment by tax officials in host countries with a reputation for institutional weakness in tax administration. Accordingly, avoiding contact with tax official during the first few year of operation following an initial investment is one reason the DFI . Effective LTUs may provide scope for cutting back on tax holidays extended to foreign investors ,in part, so that the foreign direct investors did not have to deal with a corrupt regular tax administration outside the LTUs.

The LTU accomplishes its goal though (i) reorganizing from a tax to a functional structure, (ii) reducing the potential for corruption by automating and restructuring control systems, (iii) strengthening the audit function, (iv) changing attitudes of officials toward taxpayers; and (v) simplifying and reducing paper handling through appropriate use of information technology. The business operations of large taxpayers are complex, and they often have non arm's length transactions with foreign parent corporation or have branches abroad.

[6]

They resort to legal tax avoidance and aggressive tax sheltering practices more often than other taxpayers and use transactions between branches to make monitoring difficult.

The most importantly question surrounding the LTU is whether it can deter corrupt practices and administrative malfeasance by focusing on the few largest taxpayers with the resources of a highly training and closely monitored small team of elite tax administrators[7]. LTU aim to deter revenue officials from negotiating tax liabilities with taxpayers. By concentrating scarce tax administration resources, particularly auditing skills, where they are most productive, the LTU should be able permit the adoption of more sophisticated tax administration techniques such as a functional organization of internal business processes, adoption of self assessment, effective provision of taxpayer services, and effective auditing of multinational enterprises through competent policing of aggressive transfer pricing practices.

Work flows have been modified in Russia, Ukraine, and Latvia to reduce interaction between tax officials and taxpayers. The access of taxpayers is restricted to the taxpayer service areas and the public is prohibited from entering other offices. Shifting the processing of returns and payments into data processing units that have no public interface has distanced revenue officials from taxpayers. The LTU strategy implies the necessity of attracting the best officials to a tax unit specialized in large companies and may require an enhanced remuneration policy for LTU staff or enhanced career prospects as a result of having been part of this specialized group.

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[7] Dos Santos (1994) recommends that "to prevent deterioration in the quality of service, the large taxpayer offices should not control more than about 2,000 taxpayers each"

Part II: Alternative Paths to Reform for Tax Administration

Alternatives Paths to Reform

Although tax and customs administration reform projects in recent years have had country specific variations, most have sought to (i) improve the organization and management of revenue administration; (ii) strengthen the legal and regulatory framework; (iii) broaden the tax base by registering potential taxpayers; (iv) facilitate voluntary compliance; (v) improve capacity to process the massive information flows resulting from declarations filed by taxpayers, payment transactions and administrative actions; (vi) enhance availability of information about taxable transactions from third parties; (vii) develop risk-analysis capacity to zero in on cases involving potential violations of tax laws; (viii) strengthen investigation, audit and enforcement capacity; and (ix) improve appellate procedures. Large scale administrative reforms, that are often supported by loans from development banks have involved considerable experimentation with different organizational structures; strengthening of management systems; major changes in tax and customs codes; re-engineering of business processes; heavy investments in information and communication technologies; improvement of incentive systems; and active efforts to reach out to taxpayers and other stakeholders to enhance voluntary taxpayer compliance.

Semi- Autonomous Revenue Agency

The overall governance of the revenue agency will influence its autonomy in using financial resources, hiring and firing staff and taking day to day operational decisions. Different countries have adopted varying approaches with regard to the status of the revenue administration within the government. At one pole, Russia, and Kazakhstan have established a full-fledged ministry with tightly supervised responsible for tax administration. The Minister has a cabinet level status and the same level of autonomy as other ministers. A number of countries have sought radical changes around the 'how to tax problem' problem by creating independent or quasi-independent Revenue Administration Authorities**.** This became a key feature of governance reforms in Latin America in the early 1990s, starting with Peru in 1991, and followed by Venezuela, Mexico, Bolivia, Guatemala, Argentina, and Colombia. This reform also became popular in Africa in the late 1990s, with 12 countries experimenting with Revenue Boards or semi-autonomous agencies. In Asia, by contrast, only Malaysia and Singapore have given greater autonomy to their tax administrations, although other countries in the region are beginning to discuss and consider this as well. Pakistan is attempting to provide its Central Board of Revenue with more administrative freedom to capture some of the potential benefits of an SARA .

By using this approach, some countries, in particular, Bolivia, Guatemala, Kenya, Malaysia, Mexico, Peru, Singapore, South Africa, and Venezuela, have increased performance dramatically across a large number of indicators, whereas others have enjoyed more limited success. For Africa, the revenue authority model has been instituted in Ghana (1985), Uganda (1991), Zambia (1994), Kenya (1995), Malawi (1995), Tanzania (1996), and South Africa (1997). Those with greater autonomy have shown better performance since managers where more empowered and they were able to undertake reforms faster and further than those with less autonomy.[8] Many countries have attempted to use revenue administration restructuring as an opportunity to get rid of corrupt officials and unproductive staff who are often political appointees.

Case of Peru: A Successful Semi Autonomous Revenue Agency

Peru's revenue authority was one of the developing world's most successful examples of tax administration reform. By the late 1980s, Peru's tax administration had nearly collapsed and was plagued with corruption. Tax revenue had fallen from 14 percent of GDP in 1978 to 9 percent in 1988. Consequently, the government decided to radically overhaul tax administration, and the first semi-autonomous revenue authority in Latin America was established. The reforms were highly successful with internal tax revenue recovering to 13 percent of GDP by 1997 and 90 percent of large taxpayers surveyed believed tax taxpayer services had improved. The reforms had several key elements: (i) strong political support coupled with managerial expertise; (ii) granting administrative and financial autonomy to the institution; (iii) implementing radical personnel reform; (iv) investing in infrastructure and information technology; (v) and generating public support. To guarantee financial autonomy, a certain percentage of taxes collected were automatically assigned to the agency. Management was committed to developing an honest and professional staff. All staff members were given the option of voluntary retirement or applying for a position in the new agency and taking a rigorous exam. To enhance morale and productivity, the new agency established salaries based on comparable employment in the private sector. The strategy of coupling the fight against tax evasion with better taxpayer services and honest administration enabled the institution to develop a constituency of support in the business community. after its successful start, suffered from decreasing political support for efficient revenue collection, a decline in the quality of the tax policy framework, and increased interference by the Ministry of Finance in its autonomy. SUNAT as a consequence has suffered a loss of standing in public opinion.. Revenue collection, at 12% of GDP in 2001, remains far above the pre-reform level.
The earliest LTU began in Peru in 1982. Thr LTU in Lima was assigned responsibilities for the most important taxpayers nation wide and it followed the Argentina model.

See World Bank (2001), *Strengthening Peru's Tax Agency*, PREM Notes, Washington, D.C. and Katherine Baer, (2002*), Improving Large Taxpayers' Compliance,*

[8] See Taliercio, Roberto, 2000, *Administrative Reform as Credible Commitment: The Link between Revenue Authority Autonomy and Performance in Latin America,* Mimeo. Harvard University

An independent revenue agencies covering all taxes or all taxes, except customs duties, have considerable autonomy and have constituted major enclaves for administrative reform in countries where the whole of government approach is not feasible. These agencies are typically constituted outside the civil service, so that its employee do not have a career path that can involve movement between the agency and the rest of government. The top management is recruited on fixed term contracts. Management has significant independence in financial, personnel and operational matters, but is accountable for delivering agreed results. Due to the considerable similarity in functions of tax and customs administrations, some countries have experimented with combining tax and customs administrations

Peru has remained the most impressive success story of a SARA in a low to mid income countries that successfully created discontinuity between the corrupt staff and captured management of the abolished agency and the newly recruited staff of the successor SARA. In their place young staff, often straight out of college with academic training concentrated in accounting and law were hired. When such a radical departure in personnel is not feasible the small enclave approach of the LTU may be more attractive as a vehicle for reform than pursuing the SARA path with its much higher associated operating costs.

Reforms of the tax administrations in Tanzania and Uganda under SARA in the 1990s resulted in short term revenue increases. But these achievements have proved difficult to sustain in the longer run. After the initial success, revenues in percent of GDP have stagnated or declined and the level of fiscal corruption seems to increase. Our research has explored factors that may explain this trend. Two factors are highlighted; one is related to the limits of autonomy, and the other to patterns of fiscal corruption

In practice, the performance record of SARAs has been mixed: some countries have improved performance dramatically across a number of indicators, while others have had difficulty attaining the expected results or sustaining initial progress.[9] Problems in performance have

[9] See Fjelstad, O-H., "Fighting Fiscal Corruption: The Case of the Tanzania Revenue Authority," Working Paper 2002.3, Chr. Michelsen, Bergen. For a more general country survey and balanced assessment, , see Taliercio,

resulted primarily from the lack of political support, tensions between the ARA and the ministry of finance, and poor organizational design, including among others weaknesses in the new accountability regime. Nonetheless, on the whole the record suggests that, with enough political push and proper design, Taliercio finds that the relatively more autonomous revenue authorities (Peru, Kenya and South Africa) have been more adept at increasing performance than the less autonomous ones (e. g: Uganda, Mexico and Venezuela)

Coping with Corruption in the External Environment

Even where enhanced wages or special bonuses have been enacted for the staff of the LTU or for all members of a SARA and good working conditions prevail, corruption may continue to thrive. Corruption in public institutions, particularly revenue agencies, has often been conducted through reasonably well-organized networks or bribery pool, where trust and reciprocity is found between network members, as described by Rose-Ackerman (1999). Indeed, such a parallel informal organization is almost always present in those countries where government or large components of government are at risk of capture. How sustainable is institutional and integrity reform when the external environment is distinguished by such conditions. According to Terkper (2003) corruption has reemerged as a serious issue in at least three of the pioneer SARAs, that is in Ghana, Uganda, and Kenya and Fjeldstad (2003) has documented the problems of Tanzania (see box). The continuation of integrity problems also suggest that special manpower policies alone may be insufficient because the integrity of institutions depends on other factors including national attitudes towards tax compliance, the effectiveness of government spending programs, effective operational procedures and detection systems (including automation) and a commitment to maintain strong internal vigilance oversight, leadership qualities within both the political executive and senior management of government agencies, and transparent rules and regulations.

Accountability Mechanisms

A recent literature, emerging from donor-supported tax administration modernization projects, has drawn attention to the inadequate accountability mechanisms between government and

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Robert Jr., "Designing Performance: The Semi-Autonomous Revenue Authority Model in Africa and Latin America." Unpublished manuscript, The World Bank, August 2003.

taxpayers. Such mechanisms have been interpreted by Gloppen and Rakner (2002) as having three components : (i) transparency or the ability of taxpayers to see decision and processes of government are derived and implemented in accordance with known rule and mandate, (ii) answerability or the obligation to provide legitimate reasons for government decisions and (iii) controllability or institutional checks and control to prevent mismanagement and abuse of power and to ensure that corrective measures are adopted when the rule are violated. Clearly, effective transparency, answerability and controllability all require a strong government commitment to designing a framework of clear and consistent set of rules and a well understood and monoitorable set of performance indicators. This literature advocates building a new of social contract to build a voluntary tax compliance relationship between citizens liable to tax and government based on transparency, answerability and controllability. It also stresses the need for developing countries to undertake efforts to improve the neutrality of tax administration efforts across to the three tax payer segments of large taxpayers, SME taxpayers and small business in the informal economy. It strongly endorses adoption of presumptive tax window for informal sector enterprise but takes snot of the reluctance of LDC to implement such approaches . [10]

Human Resources, Wage, and Integrity Issues

Management improvements in tax administration require fundamental changes in the behavior of managers and staff and their desire to make effective use of scarce resources to meet organizational objectives. In management of financial and human resources, revenue administrations are often constrained by laws and regulations that apply to the public sector as a whole. Rules for public expenditure management and staff assignments often reduce the flexibility of the revenue administration to move financial resources from one activity to another, higher productivity, activity. Traditional tax administrations fail to recognize that globalization and the opportunities create by modern information technology requires a new and different skill mix in tax administration. Revenue administration staff are usually part of the general civil service and consequently, have very little leeway to improve their salaries and incentives. This

[10] For example the Government of Uganda instructed its Uganda Revenue Authority in 1998 to implement a presumptive income tax on informal enterprises with low turnover . But according to Gloppe and Rakner (2002) the implementation of this process has not been taken up with any sign of commitment because enforcing collections from this segment is not seen as cost effective.

poses a particularly difficult problem with regard to recruitment and retention of good managers, lawyers, auditors and IT professionals needed to run a modern revenue administration

In order to improve salaries, countries opting for the independent agency model have delinked the salaries of revenue administration staff from the general civil service, thus, giving management the freedom to pay market salaries. In Guatemala, the salaries of top managers were increased very significantly. Other countries, like Jamaica, created a separate salary scale for tax administration staff. Some countries, including Russia and Albania, give managers discretion to distribute performance-based bonuses. Improvements in management information systems to support decision-making have been implemented in many reforming countries. In addition, automated financial management and human resource management systems have been put in place. Ideally training should have a goal oriented focus and capacity to meet the change objectives of the agency. In tax modernization efforts in developing countries, the staff development system, is frequently poorly organized, supply driven, not oriented toward the specific professional and skill upgrading for the agency.. .

According to Fjeldstad (2003) compensation aspects of institutional reforms in Africa should take into account the role of family networks and obligations. Increased pay rates may imply more extensive social obligations, resulting actually in a net loss to the individual. This state of affairs can develop into a vicious circle with higher wages leading to more corruption because the tax officer has to make up for the loss caused by such obligations. The rotation of officials may also give corrupt superiors undue power. They might 'sell' assignments to attractive positions or reassign officials to remote stations as a punishment for honesty. See Rose-Ackerman (1999). The scarcity of qualified personnel such as income tax auditors further reduces the potential of rotation schemes in the poorest countries.

The empirical evidence as to whether low civil service wages foster corruption is mixed. Findings from cross-country data vary depending on the wage data and corruption data used, the countries that are included in the analysis, and the research design. Van Rijckeghem and Weder (2000) collected pay data from the ILO, IMF, and country sources for 28 developing and low-income OECD nations for the period 1982-94. In cross-sectional tests they find that higher pay relative to manufacturing wages is associated with less severe corruption, as measured by the

ICRG. However, in other tests that rely only on time-series variation in the data, they find no evidence that changes in pay are associated with changes in corruption. Rauch and Evans (2000) create a wage measure for 35 developing countries based on country experts' judgments of how salaries of higher officials compared to those for private sector managers with similar training and responsibility. They find no relationship between this measure and subjective assessments of corruption in government as provided by the International Country Risk Guide (ICRG) and other firms. In their sample of 63 countries (including developing and developed nations) Swamy et al. (2001) find no relation between pay (relative to per capita income) and corruption, as measured by a graft index constructed by Kaufmann et al. (1999)

Even if a consensus were to emerge that more pay did reduce corruption, the direction of causality would be difficult to establish. If corruption takes the form of waiving fees or taxes, or increasing procurement costs, there will be fewer public resources available to compensate public officials. Corruption could lead to lower pay, rather than the reverse. There is even reason to expect that under certain circumstances higher pay might actually worsen corruption. At a given employment level, higher pay may crowd out other funding necessary for provision of services, increasing bribe-seeking opportunities by lengthening queues.

The establishment of a proclaimed autonomous revenue authority with comparatively generous remuneration packages and substantial budgets does not protect the authority from political interference. To the contrary, as observed in Uganda, it may make it a more attractive target because the authority offers both relatively well paid jobs and considerable rent-seeking opportunities. Consequently, such an authority is vulnerable to political interference, especially in personnel matters. First, even with relatively high wages and good working conditions, corruption may continue to thrive. Hiring and firing procedures may lead to more corruption. Corrupt tax officers often operate in networks, which also include external actors.

The Case of Revenue Administration Reform Imitative in Tanzania

Revenue authority model appears to have been less successful in sub-Saharan African countries than in Latin America.
Tax Administration Project (TAP) was developed in 1998-99 to improve TRA's effectiveness and efficiency with significant financial and TA resources support (US$73millions, World bank and five other donors.) Implementation was slow in the initial phases but has improved over time along with the focus of the authorities .

After the initial success, revenues in percent of GDP have stagnated or declined and the level of fiscal corruption seems to increase. A Commission on the Causes of Corruption in Tanzania reporting in January 1996 identified four factors as keys to explaining the extent and types of corruption pervasive in tax administration: (i) political intervention in the form of discretionary tax exemptions granted to business people who had the 'right connections', (ii) high tax rates and complicated regulations, (iii) the potential gain from involvement in corruption could be considerable, both for officials and taxpayers. and (iv) poor pay and working conditions. The low wage levels at the tax administration compared to the private sector invited corruption. The average public employee's salary including allowances in the early 1990s inadequate

Reforms of the tax administrations in Tanzania in the 1990s resulted in short term revenue increases. But these achievements have proved to be difficult to sustain in the longer run. Tanzania Revenue Authority (TRA) was established in 1996 as a semi-autonomous tax administration agency. The choice of a revenue authority model was intended to limit direct political interference by the Ministry of Finance and to free the tax administration from the constraints of the civil service system including low wages. Adoption of the SARA framework was intended to attract and retain quality staff by paying rates above the civil service regulations, and to facilitate dismissals.

Tanzania started to merge income tax and VAT in 2001 with an LTU and plans to integrate other offices in the medium term. With the arrival of semi-autonomous status wage rates rose substantially, for some categories of staff up to ten times higher than corresponding positions in the civil service. Further emphasis was laid on strengthening accounting and internal monitoring systems and curtailing the opportunity of tax officers to deal with cases on the basis of their own discretion. The general scarcity of qualified accountants, lawyers and IT-experts in Tanzania resulted in inadequate recruitment of staff with these key skills within the intake pool of the TRA. Steps were taken to improve working conditions for employees by improving offices, expanding computer services, purchasing service vehicles. Internal audit and vigilance remained. Fjeldstad (2003) reports that in December 2000 the TRA management and board took action, resulting in many vigilance officers being 'retired in the public interest'. Secondly, despite a dramatic increase in pay rates compared with normal rates in the public sector, it was not enough to compensate for the potential gains from corruption. Assessors are considered to have wide discretionary powers to interpreting tax laws, for instance, to allow or disallow expenses or charges, or to exempt import duty on items imported Reforms of tax legislation and procedures, including measures to improve transparency in the taxpayer–tax officer relations, should therefore take place concurrently to reduce opportunities for corruption and the demand for corrupt services..

In 2003 Tanzania was in the second year of a program of technical assistance, funded by the European Union, in support of the Large Taxpayer Unit and VAT Department. Part of a continual training component has been a series of management courses in UK for senior VAT managers covered corporate planning methods and information systems, how to develop risk analysis documentation for VAT operational systems, and broad management skills.
As of 2003 the .TRA is still organized as a tax-type organization and tax procedures are not based on self assessment
According to a recent Fund diagnostics: misallocation of TRA resources, high compliance costs for taxpayers , inadequate taxpayer services, duplication of functions, weak compliance strategies remained unresolved issues

Taxpayers Classified by Size Distribution:

Large taxpayers:

500 enterprises = about 70 % of domestic tax collections

Medium-size taxpayers:

13,000 enterprises registered for VAT = about 25 % of domestic tax collections

Small taxpayers:

100,000 small businesses = less than 5 % of domestic tax collections

LTD should be a model of integrated structure / procedures based on voluntary compliance
LTD should help secure / improve revenue collections (from the start of modernization process...)
Develop new procedures and computer system in the LTD
Establish integrated tax offices for medium-size taxpayers (first in Dar es Salaam)
Authorities are evaluating proposals to establish new tax offices to administer presumptive taxes to be paid by small businesses.
Sources: Bodin (2003), Fjeldstad (2003) and Crown Agents (Web, 2003)

Empirical Evidence on LTU Revenue Productivity Impacts

According to dos Santos (1994) in Uruguay, large taxpayers showed a late filing rate of more than 10 percent before the large taxpayer monitoring system became operational; the rate has since been reduced to less than 3.8 percent

Dos Santos (1994) reports that the large taxpayer monitoring system can improve collection results in the short-medium terms. The mere introduction of this system can lead to change in the behavior of taxpayers. In a study carried out in a Latin American country in 1992, the change in the value-added tax (VAT) paid by 1,400 taxpayers included in the system in 1990 was measured for 1989 and 1991. There was a 22 percent increase in the VAT revenue in constant values (see Table ---). Economic growth over the same period was 4 percent. In 1993, a second study was made--on additional taxpayers included in the system-- and the results were similar.

Table 2

. Change in Taxpayer Behavior, 1989-91, After Inclusion in Large Taxpayer Monitoring System (Amounts in local currency constant values)

SECTOR	NUMBER OF TAXPAYERS	VAT PAID IN 1989	VAT PAID IN 1991 1/	CHANGE IN COLLECTIONS	CHANGE IN COLLECTIONS (IN PERCENT)
Industry	605	21,181	22,958	1,777	8.39
Trade	627	17,457	24,182	6,725	38.53
Other	155	7,106	8,860	1,754	24.68
Total	1,387	45,744	56,000	10,256	22.42

Source : Dos Santos (1994)

(To be augmented with a cross section econometric study .)

Notes Towards Conclusions

In general, an ARA has more flexibility in managing personnel and finances and more control over corporate governance relative to the typical government agency. At the same time, it also has clearer and more transparent accountabilities. Like the independent central bank in the case of monetary policy, it was designed to resolve a credible commitment problem: if properly functioning ARA signals taxpayers that tax policies and regulations will now be credibly enforced. For the general taxpayer, it means that everyone will pay his "fair" share of financing public goods and services. And. it also means that compliance will be easier because the transactions costs of paying taxes would be reduced. The overall implication thus was that collections would increase and service would be more taxpayer friendly.

Campos (2004) suggest that enclave approach to public sector reforms, of which the LTU is an important narrowly defined case, may be the only option for success in states with weak capacity to implement whole of government reforms. Given the politically reform challenges and implementation capacity constraints of overhauling the "whole of government", for many developing countries, enclaves may be the only option with a reasonable probability of success. Comprehensive reform approaches strain limited institutional capacity, generate more than the tractable level of opposition from any stakeholder, and thus may stall and fall apart before reaching their desired ends.

Findings by Levy and Engberg-Pedersen (2004) on the African experience with administration reforms in both revenue and expenditure systems suggests that more narrowly focused, strategic interventions may be more successful over the long run. Moreover, among the more narrowly-focused reforms, the capacity building initiatives focused on accountability were considerably more successful than those focused on human resource management. They conclude that the more technical nature of expenditure accountability reforms may have been less threatening to vested interests than the more politically sensitive administrative reforms, and perhaps more importantly, that these reforms produce more readily observable results that generate needed support from the general public.

.**Table 3**

Schematic Matrix of Environmental Conditions and Probability of Success of Public Sector and Revenue Administration Reform Initiatives

SCOPE OF REFORM	SUPPORT FOR REFORM FROM POLITICAL LEADERSHIP AND EXTERNAL STAKEHOLDERS	CHARACTERISTICS OF COUNTRY AT OUTSET OF PUBLIC SECTOR GOVERNANCE REFORM		
		Partially captured state	**Administratively weak governance improving**	**Capable developing state**
A: Comprehensive reform	**Strong**	Unsatisfactory	Uncertain Outcome	Highly Satisfactory
	Partial	Unsatisfactory	Unsatisfactory	Satisfactory
B: Single institution revenue Semi-autonomous revenue agency	**Strong**	Satisfactory	Satisfactory	Satisfactory
	Partial	Unsatisfactory	Uncertain Outcome	Satisfactory
C. Narrowest reform Small Enclave LTU	**Strong**	Partial /Satisfactory	Satisfactory	Satisfactory
	Partial	Unsatisfactory	Uncertain Outcome	Satisfactory

Adapted from: Pedersen and Levy

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